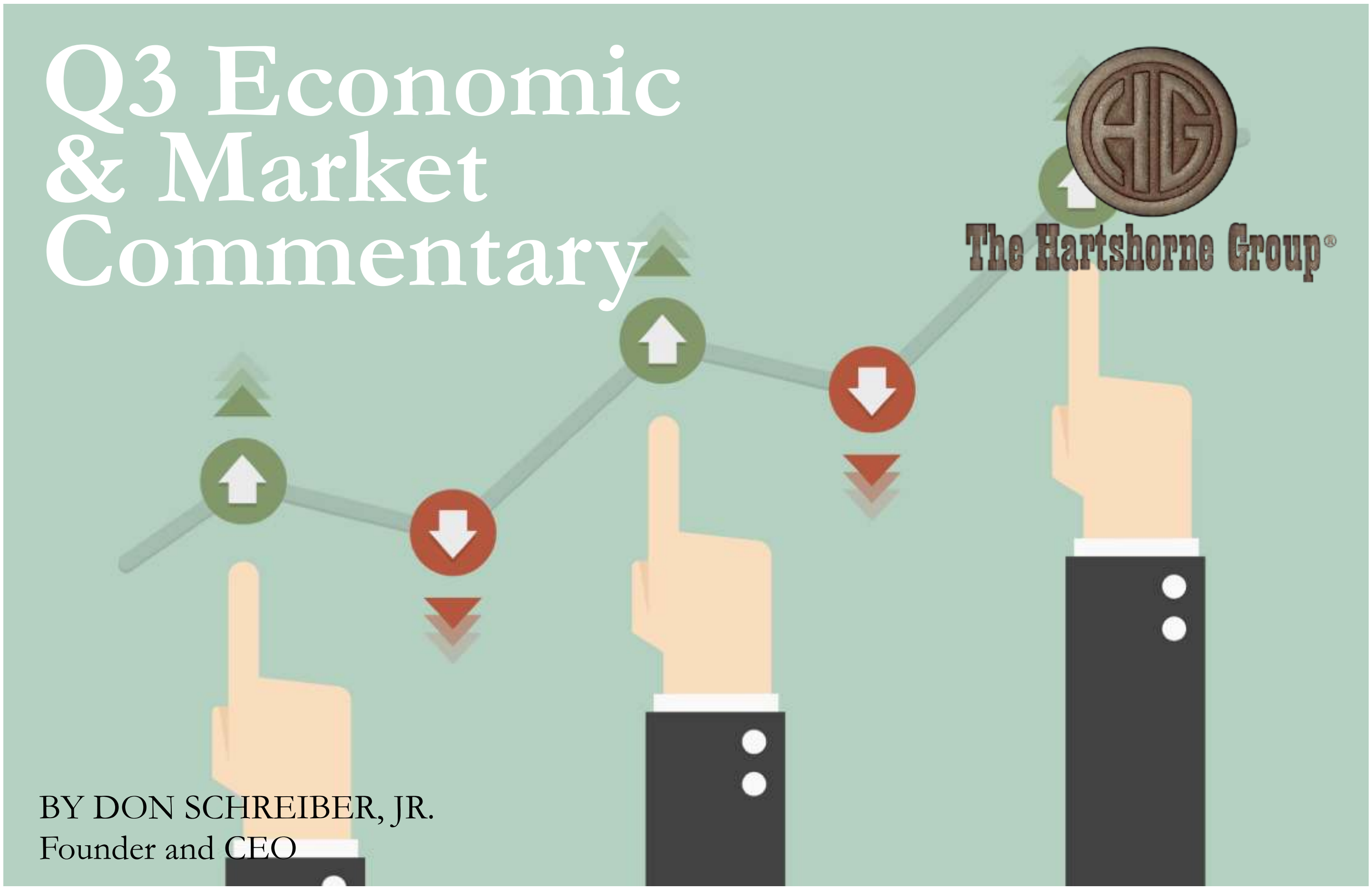
Q3 Economic & Market Commentary



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I have probably used the word lemming at least fifty times when describing a group of market participants that appear to be largely responsible for some significant price action and volatility during the past quarter. Given such frequent use, I suddenly felt the need to do a bit of research on the poor animal before I continued to abuse the metaphor. These small rodents are actually quite cute (assuming you think gerbils are cute). They travel in large herds and have periodic enormous population booms. Due to this population growth, various misconceptions and myths have developed over the centuries. One sixteenth century geographer believed they would suddenly generate in the atmosphere and fall out of the sky. Others believed they would spontaneously explode when the population grew too large. And of course, the most famous misinterpretation is that lemmings blindly follow the herd to commit mass suicide by leaping off cliffs into the sea with the instinctual goal of reducing their population size. The truth appears to be that occasionally, lemming herds do die when swimming too far in search of new territory, but not with the dramatic horror of a deliberate mass suicide.

OK, research and fact check complete. I am still resolute in my belief we are currently seeing large herds of investors blindly following the crowd simply because that's where everyone is going. They do not evaluate the quality of an investment but collectively run forward assuming everyone must know something that they too should know. These investors violently change direction when they see the herd heading somewhere new (causing enormous swings in the market). Unfortunately, just like lemmings, although no investor deliberately jumps off the cliff, this type of human behavior can lead to catastrophic portfolio losses.

Our goal here at WBI Investments is to help clients avoid becoming part of the herd. We are constantly searching for better investment opportunities with quality fundamentals. We do not blindly follow a crowd that is driven by psychological forces and the fear of missing out. Furthermore, we focus on protecting investor capital and helping our clients avoid significant losses when the herd keeps running straight towards those dangerous cliffs ahead.

Markets in Review

The third quarter of 2019 was eerily similar to the second quarter in many ways. Looking only at the S&P 500 Index for a moment, May produced a significant -6.58% decline followed by a June rebound of 6.89%. During the third quarter, an August decline was sandwiched between two slightly positive months. The result was a 1.19% return for the quarter and highlights once more that this year's return comes almost entirely from the first quarter and especially the month of January. Volatility continued throughout the third quarter as new trade tariffs and Fed concerns set up a rapid 6% decline in the beginning of August followed by three failed attempts to rally back higher.

Index Type	Selected Index	Q3 2019	YTD 2019	Trailing 12M
US Overall Equity	DJIA	1.19%	15.39%	1.73%
US Overall Equity	S&P 500	1.19%	18.74%	2.15%
US Overall Equity	NASDAQ Composite	-0.09%	20.56%	-0.58%
US Overall Value Equity	Russell 3000 Value TR	1.23%	17.47%	3.10%
US Large Cap Value Equity	Russell 1000 Value TR	1.36%	17.81%	4.00%
US SMID Value Equity	Russell 2000 Value TR	-0.57%	12.82%	-8.24%
US Fixed Income	Barclays US Aggregate TR	2.27%	8.52%	10.30%
Global Fixed Income	Barclays Global Aggregate TR	0.71	6.32%	7.60%

Unless otherwise indicated, the source for all price and index data used in charts, tables and commentary is Bloomberg. Past performance is not a guarantee of future results. You cannot invest directly in an index.

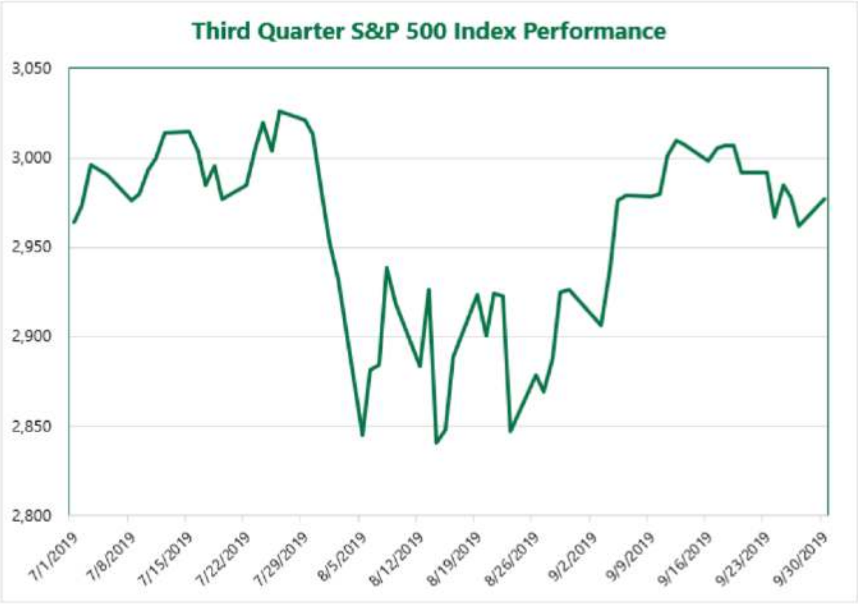
Although mainstream media continues to focus on relatively attractive year to date returns, one must remember that on a trailing 12-month basis, the S&P 500 is up only 2.15% since last September. Pushing the point even further, the S&P 500 is up only 3.62% since a peak reached in January of 2018. Looking back over those past 612 days, the S&P 500 was negative, or below that January 2018 watermark, almost 70% of the time. Indices focused on stocks with strong value characteristics have performed even worse. Large company value stocks, as represented by the Russell 1000 Value Total Return Index, are up only 1.98% since that January 2018 peak. Small and mid-sized company ("SMID") value stocks, as represented by the Russell 2000 Value Total Return Index, are actually down -4.99%, and on a trailing 12-month basis, they are down -8.24%. In short, equity markets have certainly demonstrated periods of high volatility for almost two years now, but they really haven't moved higher to the degree that most people assume.

In contrast, lower interest rates and a flight to quality helped fixed income assets perform well with the Bloomberg Barclays U.S. Aggregate index returning 2.27% in Q3 and 10.30% over the past 12 months.

The Market's Wild Ride

An increase in volatility combined with the lack of a sustained trend continued to make this quarter quite challenging. The markets were constantly at the mercy of rapid fire "tweets" and other news fragments, many of which were later revealed as fake or at least questionable. But that didn't stop the lemmings from running full speed ahead in one direction or another. The result was sudden spasms and market movements that diminished the efficacy of value-added money management.

Looking at the performance of the S&P 500 during the quarter in the chart below, we can almost see the anxious herd making convictionless trades as markets were affected more by random psychological forces rather than fundamentals. The quarter started with the firm expectation that the Federal Reserve would lower interest rates for the first time since the Great Recession at its July meeting. They did cut the fed funds rate by 25 basis points (a basis point is 1/100th of one percent), but the market was very unhappy with the surrounding commentary. Fed Chairman Powell declared that this cut was a "midcycle adjustment to policy" rather than suggest this was the beginning of a new cycle of rate cutting. The market sold off significantly as it became concerned that getting what you want isn't good enough.



Things got worse from there as one can see on the chart. On August 1st, President Trump announced new 10% trade tariffs on the remaining $250 billion of Chinese goods that were not yet taxed to begin on September 1st. The week of July 29 through August 2nd became the worst week of 2019 as the S&P 500 lost almost 100 points or 3% of its value. On August 5th, another huge selloff occurred as China hit back with what many viewed as "currency manipulation" and threats that it would suspend imports of U.S. agricultural products. On the same day, the ISM Non-Manufacturing Index reported a decline to a three-year low of 53.7. This suggested the weakness already noted in the export-focused manufacturing sector might be spreading into the country's much larger services sector.

The rest of August was a full-blown roller coaster ride. Markets were happy one day as some trade tariffs were delayed until December 1st but terrified the next day as protests in Hong Kong became more violent. More yield curve inversions startled many market participants who suddenly felt that the next recession was imminent. Weaker than forecast Chinese retail sales and industrial output, signs of German economic contraction and other gloomy global data sent investors running for cover worldwide. But then Fed officials or President Trump would say something that sent the market rocketing higher once again.

Fear and Anxiety

Nobel-Prize winning economist Robert Shiller recently offered his opinion on when the next recession might arrive and what it might look like. However, he was mostly focused on how human behavior might accelerate or even exacerbate the recession. In a New York Times article, he reminded readers that in 1933, during perhaps the worst part of the Great Depression, President Roosevelt famously tried to bring calm by saying, "The only thing we have to fear is fear itself." Further, he pointed out how President Bush echoed the sentiment during the Great Recession in 2008 by stating, "Anxiety can feed anxiety."

Shiller went on to remind us that typically, when people become concerned that something bad might happen, they adjust their behavior in an attempt to prepare for the worst. Unfortunately, their adjusted behavior might bring "the worst" to life faster than if they were never fearful or anxious in the first place. For example, if consumers are concerned about potentially losing their jobs, they will begin to save rather than spend their money, and this will decrease overall demand for goods in the economy. Similarly, if businesses are concerned about a lack of demand, they might decide that the prudent course of action is to lay-off employees and stop investing in new business lines. Unfortunately, these actions will generally increase the probability of the recession that is feared by those who are trying to avoid it.

Fear and anxiety cause similar problems directly in the financial markets. Investors often panic in lemming-like herds. Sharp market declines cause nervous traders to sell securities because they are fearful of further declines. However, when a critical mass becomes anxious and begins to sell more rapidly, further massive declines are all but guaranteed.

With that in mind, according to Bank of America Merrill Lynch strategists, "investors haven't been this bearish since the collapse of Lehman Brothers … [and] over the past six months, money market funds attracted $322 billion of inflows, the largest flight to safe assets since the second half of 2008." In other words, despite falling interest rates, investors are selling securities and raising their cash holdings at a rapid pace.

The opposite is true as well though. When fear and anxiety are alleviated, we see large groups of investors blindly piling back into the market as fast as possible. As mentioned above, this type of fearful selling followed by exuberant buying is what caused so much volatility and the sawtooth chart pattern that whipsawed markets throughout much of the third quarter.

Be Smart and Don't Join the Herd

Sometimes it seems like there are almost countless issues affecting the markets right now. Persistent trade tensions, slowing global growth, recession indicators flashing code red, Brexit, negative interest rates, and an impeachment investigation are just some of the hot topics making markets nervous every day. On the other side, U.S. consumers still have confidence, inflation is on target, the economy is still expanding, stocks are near all-time highs, and unemployment is the lowest it's been in 50 years.

As a quick aside on that last observation, I do like to highlight although it's impressive that December 1969 was the last time unemployment was this low, a recession began only one month later and within a year, the unemployment rate grew from 3.5% to 6.1%.

But my real point here is that investors are currently dealing with a slew of both positive and negative news stories, and, it's not always clear whether the news is good or bad. The result is a volatile market in which anxious investors are either chasing new highs or running for the exits. They are not paying attention to fundamental value and are motivated instead by the fear of missing out and the comfort that they are part of the herd. The problem is that no investor has the ability to time the market perfectly. So, if you are constantly switching direction trying to keep up with the latest news blip, you are going to find yourself buying high and selling low over and over again.

Unfortunate investors who desperately try to keep up with the herd probably won't spontaneously explode like lemming mythology, but it's very possible they will find themselves falling off a proverbial cliff at some point and losing a significant amount of wealth.

Here at WBI, we focus on using a portfolio management approach that helps our clients avoid becoming part of the herd. Our quantitative models and disciplined investment processes have helped us manage risk to capital for institutions and private investors for over 30 years. Our goal is to see clearly through the confusion of the masses and search for better investment opportunities with quality fundamentals. We do not blindly follow a crowd that is driven by psychological forces. Rather, we target competitive long-term returns with substantially less risk to protect capital and avoid catastrophic losses that may be on the horizon.

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Index Definitions

- The NASDAQ Composite Index (NASDAQ) is a market-value weighted index of all common stocks listed on NASDAQ.
- The Russell 3000 Index is a float-adjusted market-cap weighted index that includes 3,000 stocks and covers 98% of the U.S. equity investable universe.
- The Russell 1000 Index is a float-adjusted market-cap weighted index that includes the largest 1,000 stocks by market-cap of the Russell 3000 Index.
- The Russell 2000 Index is a float-adjusted market-cap weighted index that includes the smallest 2,000 stocks by market-cap of the Russell 3000 Index.
- The Russell 3000 Value TR Index uses the value characteristic book-to-price ratio to create a total return style index based upon the Russell 3000 which includes the performance effect of the dividends paid by stocks in the index.
- The Russell 1000 Value TR Index uses the value characteristic book-to-price ratio to create a total return style index based upon the Russell 1000 which includes the performance effect of the dividends paid by stocks in the index.
- The Russell 2000 Value TR Index uses the value characteristic book-to-price ratio to create a total return style index based upon the Russell 2000 which includes the performance effect of the dividends paid by stocks in the index.
- The MSCI ACWI Index is a free-float weighted index including both emerging and developed world markets.
- The Barclays U.S. Aggregate TR Index is calculated based on the U.S. dollar denominated, investment grade fixed-rate taxable bond market including treasury, government-related, corporate, MBS, ABS and CMBS debt, and includes the performance effect of income earned by securities in the index.
- The Barclays Global Aggregate TR Index is calculated based on global investment grade debt from twenty-four local currency markets including treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers, and includes the performance effect of income earned by securities in the index.

Annualized Rate of Return is the return on an investment over a period other than one year (such as one quarter or two years) multiplied or divided to give a comparable one-year return.

The Dow Jones Industrial Average (DJIA or "The Dow") is a price-weighted average of 30 of the largest and most significant blue-chip U.S. companies.

The S&P 500 Index is a float-market-cap-weighted average of 500 large-cap U.S. companies in all major sectors.

SOURCES

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[ii] https://www.bloomberg.com/news/articles/2019-10-11/money-markets-haven-t-seen-such-inflows-since-lehman-s-collapse
[iii] https://www.cnbc.com/2018/10/08/the-last-time-unemployment-was-this-low-something-bad-happened.html

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